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KEY ECONOMIC INDICATORS

(In billions of U.S. dollars unless noted)

	1987	1988	1989	1990*
Domestic Economy				
Population (millions)	10.62	10.62	10.57	10.51
Population Growth (%)	(.1)	0	(.5)	(.5)
GDP (current dollars)	24.0	23.9	23.66	23.19
GDP per capita ($1,000)	2260	2250	2238	2206
GDP growth (%)	4.1	(.1)	(1.0)	(2.0)
CPI growth (%)	8.6	15.7	17.0	22.0
Production and Employment				
Labor Force (thousands)	4885	4845	4800	4750
Industrial production volume growth (%)	3.8	(.4)	(3.4)	(5.0)
Agricultural production volume growth (%)	(1.5)	(.5)	(2.0)	(2.0)
Balance of Payments				
Convertible currency account				
Exports	5.014	5.50	6.45	7.40
Imports	5.011	5.01	5.91	6.60
Trade balance	.003	.49	.54	.80
Current account balance	(.85)	(.81)	(1.4)	(.6)
Nonconvertible current account				
Exports	4.91	4.48	4.1	3.7
Imports	4.87	4.39	3.5	3.6
Trade balance	.41	.94	.5	.1
Current account balance	.20	.23	.87	.2
Gross convertible debt	19.58	19.60	19.63	22.0
Net convertible reserves	2.16	1.98	1.46	1.2
Average exchange rate (x HFT = $1.00)	46.98	50.42	60.0	70.0
U.S.-Hungarian Trade**				
U.S. exports to Hungary	.095	.078	.122	.16
U.S. imports from Hungary	.255	.321	.32	.45
U.S. % share of Hungarian convertible currency market				
-Hungarian exports	5.0	5.1	5.6	5.3
-Hungarian imports	1.80	1.3	1.6	1.8

Sources: National Bank of Hungary, Hungarian Central Statistical Office, IMF, U.S. Department of Commerce.

*Estimated. **Differs from Hungarian statistics.

SUMMARY*

In April 1990, Hungary elected its first democratically chosen government in 45 years. The new non-communist coalition government plans to accelerate the pace of economic reforms began by the outgoing communist regime in 1988 and 1989.

The old regime's attempts to balance internal and external accounts while encouraging transition to a market-oriented economy produced mixed results. Real GDP fell slightly in 1989 and has declined through the first six months of 1990. Many state industries and farms have seen both production and profitability shrinking. Retail turnover suffered from declining living standards and from increased shopping in the West. Moreover, although an increase in convertible currency exports helped reduce Hungary's hard currency current account deficit in 1988, the deficit grew again in 1989. At the same time CMEA trade surpluses continued to grow despite a strong desire to reorient trade to the West. Hungary also continued to face large budget deficits. Furthermore, introduction of new taxes and reductions in price controls pushed the official inflation rate to 17 percent in 1989, and to over 20 percent through the first six months of 1990. Still, Hungary remains firmly committed to meeting its external debt requirements.

Despite the downturn, reforms have opened new opportunities for U.S. business. Over 60 percent of hard currency imports are now free from licensing requirements (up from 10-15 percent), and Hungary plans to liberalize 80 percent by 1991. Profitable companies have easier access to hard currency to purchase these imports. Planned shifts away from CMEA trade as well as adoption of the 1988 Hungarian-European Community agreement may lead to new areas of sales and cooperation.

Moreover, Hungary is committed to attracting the Western investment needed to build a free market economy. The Law on Corporate Association and the Act on Foreign Investments, both in effect since January 1989, allow for new forms of business, including joint stock and limited liability firms; 100 percent foreign ownership of existing Hungarian firms; and repatriation of all soft currency profits. As a result, the number of joint ventures in Hungary has grown to over 1800, including about 150 involving U.S. partners. U.S. investors so far have focused on light manufacturing, services, and consulting.

U.S. products continue to maintain good potential for direct sales to Hungary. U.S. exports increased during 1989. World Bank credits make sales possibilities best in agriculture, energy, process industries, telecommunications, and transportation.

* This report was prepared by the American Embassy Budapest in September 1989 and updated by the U.S. Commerce Department's International Trade Administration in July 1990.

PART A: CURRENT ECONOMIC SITUATION AND TRENDS

Overview -- Resource, debt constraints reinforce impetus toward reform and foreign trade, but political obstacles remain: Hungary possesses few natural resources other than extensive agricultural land, rich bauxite deposits, and some lesser coal, oil, and natural gas deposits. However, a strategic location in the heart of Central Europe, a dynamic, well-educated population, and a 20-year history of economic reform efforts have combined to give the Hungarian economy a remarkable degree of openness even before the recent political revolution. Foreign trade, divided approximately evenly between CMEA (ruble) and convertible currency markets, accounts for over half of the gross domestic product (GDP). In addition to its CMEA membership, Hungary belongs to the International Monetary Fund, the International Finance Corporation, the General Agreement on Tariffs and Trade (GATT), the International Wheat Council, and the International Bank for Reconstruction and Development (World Bank).

Significant reforms occurred in 1988, including a new Law on Corporate Association, which by permitting joint stock and limited liability companies, set up new operating rules for both foreign and domestic firms, and a Foreign Investment Act that allowed 100 percent foreign ownership of Hungarian businesses, simplified registration procedures, and conversion of soft currency profits into foreign exchange for repatriation. The former regime also established the first personal and value-added tax systems in Eastern Europe and took steps towards a reform of the wage and price systems. The CMEA's only operating stock and bond markets are in Budapest. Also in 1989, the government reduced import regulations, continued the development of a modern banking sector, and announced cuts in some government consumer and production subsidies.

Hungary also hopes the ongoing trade negotiations stemming from its 1988 agreement with the European Community will result in improved market access. With an eye toward promoting trade and investment, Hungary has also expanded its political ties with Israel and South Korea.

Despite the former regime's reform efforts, economic results in Hungary in 1988 and 1989, like those of the previous two years, remained disappointing. GDP -- 63 percent of which still passes through the central budget -- stagnated in 1988 and fell slightly in 1989, while government deficits continued to exceed government projections. Inflation, officially 17 percent in 1989 and running above 20 percent so far in 1990 (but considered by many to be higher), and the reduction of consumer subsidies with resulting price hikes continue to be serious political issues. In 1988, real wages dropped by 8 percent, and

consumption by 3 percent. Although wages in 1989 on average grew slightly in real terms, a further erosion in living standards for some segments of the population is expected as obsolete industries shut down; a full fifth of the population lives below the official poverty line. Concern also is growing that the government's restructuring program may push unemployment above 100,000 by the end of 1990.

Moreover, profitability of state firms remains a particularly elusive goal. Some estimates put the number of state and cooperative enterprises operating in the red as high as 500 and loss-making cooperative farms at over 100, yet only a small percentage of these (and mostly smaller units) have been forced into bankruptcy. Subsidies to others, in spite of some cuts, remain stubbornly high. Debts between companies are estimated to total nearly $1.2 billion. In addition, Hungary's $21.7 billion gross hard currency debt is a constraint that will grow as medium- and long-term debt matures.

In sum, all the reform and austerity-oriented activities undertaken by the previous regime have not added up to dramatic results. Moreover, the new government, while committed to the objective of a free market economy, may have to move slowly in the face of popular resistance to the pain that needed reforms will bring.

Industry -- State sector declines and privatization slows: Throughout 1989, the volume of Hungary's industrial production fell slightly compared to projected stagnation. This decline was most severe in the state sector, which predominates with nearly two-thirds of all production, but was also characteristic of cooperative enterprises. The mining and light industry sectors, both subject to cutbacks in government subsidies, were the hardest hit, while metallurgy, thanks to a 10 percent increase in aluminum production due to high world prices, registered the highest growth, 4 percent. Government planners were most concerned with stagnation in the chemical and machinery/engineering sectors, which are expected to form the foundation of a restructured Hungarian economy but which do not yet show signs of change.

Recognizing that production from Hungary's small private sector remained the most dynamic, Hungary's former government took steps throughout 1989 to allow for an economy based on mixed ownership. To encourage existing firms to take advantage of the new forms of ownership opportunities allowed in the 1988 Law on Corporate Association, Parliament passed the Law on Economic Transformation in May 1989, which set up the conditions under which a state-owned or cooperative firm may convert to other forms of ownership, including limited liability or joint stock. In a formula based on the type of state company involved, part of the revenues from the sale of the state assets would be

returned to the firm as an incentive to convert ownership structure, with the rest going into a State Fund for Privatization. By loaning investment capital from this fund, the government hoped to find buyers for additional state assets.

Creatively using the new opportunities, a handful of former state companies have successfully denationalized. In one well-publicized case, the employees of a Budapest retail chain took equity in the company, while other enterprise councils voted to sell their firms to foreign investors to get needed capital and know-how. For the most part, Hungary's commercial banks and other financial institutions rather than private citizens or foreign firms remain the major investors in local companies. In spite of the new possibilities, many state firms have been reluctant to denationalize -- managers and employees often see only the risks of lost jobs and influence rather than the opportunity. The pace of denationalization may accelerate in the near future as foreign investors and the Hungarians themselves become more used to the process. However, many Hungarians resist rapid privatization out of fear that many state enterprises will be sold to foreigners at undervalued prices.

Balance of Payments and Finance: Largely through increased convertible currency exports, Hungary reduced its convertible currency current account deficit from $1.41 billion in 1986 to $847 million in 1987 and $810 million in 1988. After this two-year improvement, however, the deficit ballooned back up to $1.4 billion in 1989, mainly as a result of increased travel of Hungarians to the West. The tourist surplus, traditionally a significant source of hard currency earnings, dipped to a mere $3 million in 1988. Throughout 1989, government officials worked with customs regulations and domestic supplies to reduce Hungarian "shopping tourism" in Austria and Western Europe, without restricting popular travel opportunities available to the population with the adoption of liberal passport laws in 1988.

The trade balance remained a star performer during this period, somewhat counterbalancing the tourist outflows. With over 50 percent of GDP tied to trade, export success remains key in efforts to balance accounts while simultaneously encouraging industrial restructuring. In both 1988 and 1989, convertible currency export volumes increased by 9 percent. The 1989 trade surplus was $540 million, up from $490 million in 1988, thanks to a 17 percent rise in export values. Convertible currency imports rose 18 percent last year, however, probably as a result of the liberalization of import licensing requirements. Many government officials worry that Hungary's recent trade performance stems more from luck -- higher world prices for traditional Hungarian exports -- than from any successful economic restructuring.

Hungary's trade is now divided almost evenly between convertible currency and CMEA markets, with the Soviet Union, West Germany, and Austria ranking as the country's top three trading partners. Hungary buys 80 percent of its energy and raw material imports from the Soviet Union. In a move to reduce Hungary's growing ruble surplus in its CMEA trade in order to free up more resources for Western export, Hungary revalued the forint-ruble exchange rate in September 1989. Hungary and the Soviet Union have agreed to base bilateral trade on a convertible currency basis by 1991, and the CMEA as a whole has similar plans.

Although Hungary's convertible currency debt of $21.7 billion is the highest per capita in Eastern Europe, Hungary has been able to maintain a high level of international lendor confidence through a strong commitment to its debt obligations. Central bankers have worked consistently to trade short-term debt for loans with longer maturity and to diversify the sources of currency fluctuations. U.S. holding of Hungarian loans and bonds is minimal, while Japan, with nearly half of the total debt, is Hungary's largest creditor. Hungary's debt service obligations are expected to rise substantially beginning in 1991 and 1992, to an estimated $3 billion. Hungarian officials hope that by then the effects of restructuring efforts will show through substantially increased hard currency exports, although not everyone anticipates this result.

In March 1990 Hungary concluded a standby agreement with the International Monetary Fund (IMF). Continued international lender confidence in Hungary will be strongly influenced by the government's ability to abide by the principal terms of this agreement, which are to shrink the current account deficit and reduce the government's large budget deficit. Moody's investor service has rated Hungary Aa2, identical to that of Spain.

PART B: IMPLICATIONS FOR THE UNITED STATES

Trade opportunities best in agriculture, process industries, transportation, telecommunications, and energy sectors: Hungary must continue to rely on imports of Western management, technology, and capital equipment if it is successfully to privatize its economy. Toward this end, Hungary in January 1989 released 40 percent of its convertible currency imports, consisting largely of manufactured goods and some agricultural products and fodder grains, from licensing requirements. This was increased to 60 percent in 1990, and officials plan to have up to four-fifths of all imports liberalized by 1991. Through related financing reforms, profitable Hungarian enterprises can

now work directly through the growing number of commercial banks to purchase these goods. The Hungarian firm must have the forint equivalent of the convertible currency price or a bank guarantee, but no longer must it earn hard currency to buy hard currency imports.

Still, with chronic hard currency constraints and remaining import licensing restraints, Hungarian importers will continue to seek countertrade and long-term cooperation. This can mean anything from joint research and development to working in third markets. Both Hungary's agreement with the European Community and CMEA's anticipated move to place all trade within the CMEA on a convertible currency basis may provide additional opportunities for cooperation and sales in third countries. Since 1988, all Hungarian companies have been free to import and export without working through the state foreign trading offices (FTOs), which used to have monopolies over Hungary's foreign trade. In reality, however, many firms still rely on the FTOs for their foreign trade relations. It may be sometime before Hungarian importers develop the skills to deal directly with outsiders.

Despite its very real economic and financial constraints, the Hungarian Government has repeatedly stated its interest in expanding two-way trade with the United States. Hungarians have long admired the quality of U.S. products and technology. Although in 1989 the dollar strengthened, the overall decline in its value over the past few years against the yen, Deutsch Mark and related Common Market currencies gives U.S. products a competitive edge lacking a few years ago. Examples of U.S. heightened competitiveness include the 1987 sale of agricultural helicopters to the Ministry of Agriculture and the dramatic increase since 1988 of U.S. bids on World Bank-financed restructuring tenders. In 1989, a Hungarian agricultural cooperative using World Bank credits contracted to buy U.S.-produced agricultural irrigation systems worth $25 million.

U.S. agricultural and industrial equipment continue to have relatively good potential for direct sales. Best products include electronics, production equipment and technology, computers, telecommunications equipment and technology, food processing and packaging equipment, specialized agricultural equipment, agricultural chemicals, pharmaceuticals, petrochemical production technology and equipment, pollution control equipment, and energy conservation systems and technology. The availability of World Bank financing has made the potential for direct sales greatest in the agricultural, energy, process industries, telecommunications, transportation, and chemical sectors.

In addition, Hungary's plans to replace its command economy with a free market economy have created a market for managerial and production consulting. In July 1989, the U.S. Trade and Development Program (TDP) and Hungary signed an agreement to provide funding for studies on the redevelopment of an economically depressed area in eastern Hungary. World Bank financing continues to be available for other consulting projects. Sectors in greatest need of such services include meat processing, mining, energy safety and conservation, telecommunications, environmental systems, metallurgy, and construction. The desire to increase Western exports at the same time creates a need for improved packaging and marketing. Recent decisions to liberalize further COCOM multilateral export controls promise to broaden sales of nonstrategic high technology equipment. The number of items affected by these controls, particularly related to personal computers and telecommunications equipment, will be substantially reduced. Exporters should consult with the Department of Commerce's Bureau of Export Administration on export licensing requirements.

Outside of the CMEA, Hungary's traditional trading partners are largely West Germany and Austria. To overcome the Hungarian tendency to look first to Western Europe, American companies may find useful increased patience and attention to the Hungarian market. Trade shows offer excellent opportunities to meet Hungarian business partners. The American presence in the Budapest Spring Fair (May 1990) was at an all-time high.

Liberal joint venture laws govern investment opportunities: The new Hungarian Government views the attraction of foreign working capital as a critical factor in restructuring the economy. The Law on Corporate Association and the Act on Foreign Investments, both passed by Parliament in late 1988 and in force since January 1, 1989, provide many new opportunities for investment.

The Law on Corporate Association provides a framework for the operation of new forms of business in Hungary, including joint stock and limited liability companies, and creates a more or less level playing field for state and private businesses. Private firms, formerly restricted to 30 employees, can now hire up to 500 people, and government officials have implied that even this upper limit could be worked around, if and when the case arises.

The Law on Foreign Investment permits foreign firms to own up to 50 percent of a Hungarian enterprise without obtaining prior approval from Hungarian authorities. For a majority share (up to 100 percent foreign ownership is permitted), the foreign investor must still get such permission, but any application not

denied within 90 days is deemed accepted. Moreover, the procedures to found a joint venture, start a new company, or buy into an existing enterprise have been simplified. Furthermore, the act guarantees the repatriation of investment capital and dividends in convertible currency to the foreign partner. Morover, Hungary's nascent stock market has just become fully operational. This should make capital assets and equity more liquid and easily tradeable.

The Hungarian Government has established a state Invest Center, with a central office in Budapest and representatives in Hungary's major embassies, to work with foreign investors.

Certain tax incentives and custom allowances are designed to encourage foreign investments and joint ventures in industries believed to have great export earning potential. If the foreign share of a joint venture equals at least 20 percent of total assets, a tax holiday for up to five years is possible in certain sectors, including telecommunications, tourism, agriculture and related food processing, pharmaceutical, electronics, vehicle component production, and machinery and machine tools. The joint venture is also released from certain wage and price regulations.

In July 1989 President Bush visited Budapest, the first such visit by a U.S. President. A number of programs grew out of this visit, including relations with the Overseas Private Investment Corporation (OPIC), a Peace Corps English teaching program, a $60 million private enterprise fund, a $5 million environmental package, expanded TDP feasibility study grants, and enhanced trade and investment activity. U.S. Secretary of Commerce Robert Mosbacher visited in September 1989, along with a dozen or so business representatives--another indication of the interest the United States now has in Hungary's reform efforts. In addition, Budapest now has a branch of the U.S. Chamber of Commerce with over 100 members.

For Further Information: The U.S. Department of Commerce and the U.S. Embassy in Budapest offer a broad range of services and information to persons interested in pursuing trade and investment opportunities in Hungary. Firms seeking to do business in this market are encouraged to contact the Department of Commerce's Eastern Europe Business Information Center (EEBIC) for basic information on doing business in Hungary. EEBIC is located in Room 6043, 14th Street and Constitution Avenue, N.W., Washington, DC 20230; telephone (202) 377-2645. Visitors to Budapest should also contact the Commercial Section, American Embassy Budapest, V. Szabadsag Ter 12, telephone 36-1-112-6450. The Embassy's mailing address is U.S. Embassy Budapest, APO New York, 09213.

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